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Report to the Chairman, Resolution Trust Corporation

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RESOLUTION TRUST CORPORATION

Unnecessary Loan Servicing Costs Due to Inadequate Contract Oversight

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The Honorable L. William Seidman
Chairman
Resolution Trust Corporation

Dear Mr. Seidman:

At the request of Congressman Vento, Chairman of the Task Force on the Resolution Trust Corporation (RTC) we are reviewing the RTC's use of Interim Servicing Agreements (ISA) to determine if government interests are being adequately protected.[1] We anticipate reporting on the results of this work later this year. However, our initial work on one agreement disclosed practices that were contrary to RTC's general marketing policy and resulted in excessive loan servicing costs to the government. We are bringing this matter to your attention now because it can be used to clearly illustrate to your staff the value of having adequate controls in place and operating as part of your contract monitoring efforts.

The subject ISA was with North Carolina National Bank of Florida (NCNB) for Freedom Savings and Loan, a failed thrift based in Tampa, Florida. Our objectives were to determine ISA loan servicing costs, the adequacy of RTC's monitoring of this agreement, and whether assets were being serviced in an efficient and effective manner.

Results in Brief

From January to July 1990, RTC might have avoided as much as $1 million in loan processing costs resulting from continued operations at a large loan processing center in Orlando, Florida. These unnecessary costs resulted from inadequate RTC oversight, insufficient RTC and NCNB initiatives to plan for a large reduction in the number of loans processed at the center, insufficient cost information relating to center operations, and RTC's failure to take early action to market the center.

Background

Since February 7, 1989, Freedom, a federally-chartered thrift headquartered in Tampa, had been under the control of federal thrift regulators. On August 9, 1989, the day RTC was established, it assumed conservatorship responsibility for Freedom. Subsequently, on October 13, 1989, RTC sold parts of Freedom to NCNB. This occurred at the time RTC was both

[1] As part of the thrift sales agreement, Interim Servicing Agreements, or ISAs, were entered into by RTC and the thrift acquirer. As part of the ISA, the acquirer agreed to provide for continued servicing of assets not acquired—such as loans.

being organized and assuming a growing workload of failed thrifts. NCNB acquired assets valued at $266 million, leaving RTC assets of $633 million to manage and liquidate. One specific asset not purchased by NCNB was Freedom's loan processing center in Orlando.

The ISA between RTC and NCNB required NCNB to maintain and continue loan processing services. Under this ISA, RTC reimbursed the acquirer only for costs associated with servicing RTC assets.

Objectives, Scope, and Methodology

Our overall objectives were to determine center operating costs, the adequacy of RTC monitoring, and if assets were being serviced in an efficient and effective manner. While our review of ISAs nationwide continues, in this report we focus on the ISA for Freedom. We selected the Freedom ISA because it had been in effect since October 1989, and could provide us with information covering about 10 months.

To ascertain center operating costs, we obtained and reviewed the Freedom ISA, the Purchase and Assumption Agreement between RTC and NCNB of Florida, monthly ISA accounting statements, and other information relating to the costs RTC paid to operate the Freedom facility.

To ascertain the adequacy of RTC monitoring and asset management and disposition, we reviewed RTC's Strategic Plan and relevant operating procedures to identify RTC policies. We discussed plans, policies, procedures, and practices with RTC Southeast Consolidated Office officials responsible for monitoring the ISA and marketing the Freedom operations center; RTC Eastern Region officials in Atlanta, Georgia; and Headquarters officials in Washington, D.C. We also visited the Orlando service center in August 1990 to observe the condition of the center.

We did our work between July and September 1990 in accordance with generally accepted government auditing standards.

Insufficient RTC Contractor Oversight Resulted in High Loan Servicing Costs

We estimate that RTC might have avoided as much as $1 million in loan processing costs. (See pp. 4 and 5.) This happened because of inadequate contractor monitoring, insufficient RTC and NCNB initiatives to accommodate a large reduction in the number of loans being processed, and insufficient information on the costs of continuing to operate the loan processing center.

On October 13, 1989, NCNB and RTC signed an Interim Servicing Agreement to service those Freedom assets not bought by NCNB. NCNB assumed operating responsibility for Freedom's loan processing center for RTC. NCNB provided "dedicated" personnel—staff that spent 100 percent of their time on RTC-related activities—to run the center. The facility initially processed both the Freedom loans purchased by NCNB and those retained by RTC (a total monthly average of 10,800 loans). RTC and NCNB originally shared the costs associated with operating the center. By January 15, 1990, NCNB had transferred the 9,000 loans it had purchased to its own facilities. As of that date, RTC began incurring all center operating costs. The center was not closed until July 19, 1990. NCNB was reimbursed for its costs associated with operating the center for RTC. These included costs of dedicated personnel, computer operations, and general maintenance of the facility.

ISA provisions required NCNB to use its "best effort and sound banking judgement" to service all RTC assets. The contract also required NCNB to service the assets using ". . . the same degree of care and expertise as if . . . servicing said assets for its own account and no other." After the removal of NCNB's 9,000 loans in January 1990, RTC staff continued to operate the center with 32 employees processing an average of 1,800 loans per month—effectively increasing the cost per loan from $20 to $120 per month.[2] Initially, neither RTC-dedicated personnel nor NCNB—as part of the action to remove NCNB's loans—took actions to reduce the staffing level at the center even though about 85 percent of the loans processed there were transferred.

RTC did not have enough staff in place to adequately oversee the operation of the center to ensure that costs incurred were reasonable. The Southeast Consolidated Field Office was responsible for ensuring that the Freedom ISA provisions were performed satisfactorily. However, the unit within the Consolidated Office responsible for monitoring the ISA was not authorized until December 1989, and not fully staffed until March 1990. While NCNB was responsible for servicing the assets, RTC was ultimately responsible for monitoring the ISA and protecting the government's interests.

In March 1990, the staff monitoring the ISA (1) hired an accountant to summarize center costs, and (2) attempted to identify alternative, less

[2]We calculated estimated monthly costs by (1) dividing the monthly operating cost of $215,000 by the December loan volume of 10,794 loans—equaling $20 per loan per month; and (2) dividing the monthly operating cost of $215,000 by the January loan volume of 1,794 loans—equaling $120 per loan per month.

costly, loan servicing arrangements. One alternative identified by the consolidated field office was to make temporary arrangements with a commercial loan servicer to process the loans until RTC transferred the loans to a planned regional servicer. As of December 1989, one such cooperative was providing computer services to process loans for RTC at six conservatorships for about $1.00 per loan per month. In March 1990, this cooperative offered to provide computer servicing for the Freedom loans at $1.40 per loan—roughly $3,363 per month (RTC would have needed to provide 17 persons to handle the paper work associated with loan processing). Although the Consolidated Office's actions had disclosed the inefficient use of the center, Headquarters did not want to use a temporary servicer because the Freedom loans were scheduled for conversion to a planned regional servicer. Headquarters is adamantly opposed to loan conversions from one servicer to another because conversions may be costly and can result in a loss of payment history. The transfer to a regional servicer, however, was not completed until July 19, 1990—6 months after NCNB removed about 85 percent of the loans processed at the center.

RTC Incurred High Loan Servicing Costs

At the time of our review, only limited information was available on center operating costs. Consequently, we based our monthly cost estimate on an RTC-prepared summary of center expenses for February 1990, the first month for which RTC bore all center costs. This report showed the operating costs for February to be $296,000. We reduced this figure by about $81,000 to adjust for personnel costs, and used it to arrive at estimated monthly center operating expenses of $215,000.

We based our calculation of the loan servicing costs on (1) our estimate of $215,000 for monthly operating costs; (2) use of the previously mentioned loan servicing offer of $3,363 per month;[3] (3) additional RTC-estimated in-house loan servicing costs of $27,744 per month; and (4) budgeted monthly center expenses (i.e., maintenance) costs of $23,035. We estimated that beginning January 15, 1990, RTC might have avoided loan servicing costs by as much as $160,828 every month—a total of about $964,969 from January to July 1990. The estimates are shown in table 1.

[3]We are using this offer as an example of services that could have been obtained, since the cooperative was already servicing loans for RTC.

Table 1: Estimated Unnecessary Monthly Loan Servicing Costs

Estimated monthly center operating costs	$215,000
Less monthly:	
Alternative automated servicing costs	(3,363)[a]
RTCin-house servicing costs	(27,774)[b]
RTCbudgeted expenses	(23,035)
Net monthly excess costs	$160,828
6 months @ $160,828	$964,969

[a]This figure includes a one-time conversion cost of $5,000, telecommunications, and user support.

[b]RTCestimated that it would have needed 17 persons to handle the paperwork associated with servicing the Freedom loans in-house.

RTC Slow to Market Freedom's Loan Servicing Center

As of October 1989, the loan servicing center was listed in Freedom's accounting records at $6.4 million, and contained sophisticated computer equipment, furniture, and fixtures valued at $728,000. Contrary to the strategic plan goal of maximizing returns on the sale of thrift assets through early marketing, RTC did not begin marketing the Freedom center until July 1990. The 6-month delay was attributable to the fact that the facility was still being used to process Freedom loans.

RTC policy recognizes that delaying asset marketing may reduce net sales profits. The strategic plan states that

"... it is the Oversight Board's policy that RTC should avoid deferring the marketing of properties .... Holding properties off the market for an extended period of time may increase the ultimate costs ... because of the expenses associated with managing and financing the property ... and the risks of deterioration and vandalism."

Marketing practices on an asset of this value generally require including the property on RTC's real estate inventory, listing the property with a broker, and obtaining a professional appraisal. However, efforts to meet these requirements were not initiated until July 27, 1990, after the center was closed. By November 1990, RTC had two appraisals of the property completed. Additional costs were probably incurred by not initiating marketing efforts earlier, when it appeared that RTC would have no long-term need for the center.

Conclusions

We recognize that the Freedom ISA was one of RTC's early agreements, that the loan processing center represented only one RTC asset, and that RTC was tasked with organizing its operations at the same time it was assuming a growing workload. However, had RTC adequately monitored the Freedom ISA (i.e., identified and minimized costs) the as much as $1 million in loan servicing costs might have been avoided.

We have not completed our overall review of RTC's use of Interim Servicing Agreements for Chairman Vento; therefore, we are not making any recommendations on this particular matter at this time. However, RTC has thousands of assets in the current real estate inventory, and we are bringing this matter to your attention now to illustrate the need for and importance of timely and adequate contractor monitoring efforts. This matter should illustrate to your regional and consolidated office staff the need to ensure that adequate controls are in place and operating on other Interim Service Agreements.

Agency Comments

RTC officials told us they were adamantly opposed to loan servicing conversions from one servicer to another because conversions may be costly and can result in a loss of payment history. They said they would not have placed the Freedom loans with a temporary servicer. We believe that given the high costs of operating the center, had RTC done a cost/benefit analysis, use of a temporary servicer might have been beneficial to consider in January 1990.

RTC officials objected to the time frame that we used in calculating the loan servicing costs because RTC did not have the staff at the Southeast Consolidated Field Office in January 1990 or information available to identify the high center operating costs. We calculated the costs beginning in January 1990 to demonstrate the extent to which costs might have been avoided if appropriate staffing and controls had been in place.

Further, Headquarters officials objected to our comparison of monthly loan servicing costs for processing differing quantities of loans because they believe this distorts the costs. We believe that this is a valid comparison because costs at the center were constant and only the number of loans changed. The point we are making is that when the number of loans serviced decreased, but the operating costs for the center did not, the cost to process each loan increased significantly. The average cost per loan per month increased from $20 (for 10,800 loans) to $120 (for 1,800 loans).

Please contact me at (202) 275-8387 if you or your staff have any questions concerning this report. This report was prepared under the direction of Gaston Gianni, and its major contributors are listed in the appendix.

Sincerely yours,

J. William Gadsby
Director, Federal
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